

**Internal Revenue Service Procedures
Were Not Consistently Followed When
North Florida District Revenue Officers
Attempted to Improve Tax Compliance
in the Construction Trades Industry**

JULY 1999

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax return/Return information

2b = Law Enforcement Guideline(s)

2e = Law Enforcement Procedure(s)

3a = Identifying information - Name of an Individual or Individuals

3d = Identifying information - Other Identifying Information of an Individual or Individuals



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 21, 1999

MEMORANDUM FOR COMMISSIONER ROSSOTTI

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Internal Revenue Service Procedures
Were Not Consistently Followed When North Florida
District Revenue Officers Attempted to Improve Tax
Compliance in the Construction Trades Industry

This report presents the results of our review of the Regional Compliance Program (RCP) Project for the North Florida District Construction Trades Industry. This review was requested by the Regional Commissioner, Southeast Region, to evaluate complaints made by 3d----- regarding the treatment of taxpayers during the RCP. Allegedly, revenue officers used unauthorized techniques to work employment tax issues in the construction trades industry project, which took place from October 1993 through September 1995.

In our opinion, taxpayers may have been treated inconsistently because the two groups working these cases used different sets of procedures. The Employment Tax Examination Group received more training and followed the procedures in the Internal Revenue Manual (IRM) 5(10) for investigating employment tax issues, while the RCP group followed locally developed procedures that allowed them to make employment tax determinations without following IRM 5(10) procedures.

Southeast Region management agreed that insufficient training was provided to the revenue officers assigned to the project and that different procedures were used. They also agreed to conduct an independent review of the cases we questioned to determine if examination audits were conducted instead of the less intrusive compliance checks.

Copies of this report are also being sent to Internal Revenue Service managers who are affected by the report recommendations. Please call me at (202) 622-6510 if you have questions, or your staff may contact Maurice S. Moody, Associate Inspector General (Headquarters Operations and Exempt Organizations Program), at (202) 622-8500.

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Executive Summary

The Regional Commissioner, Southeast Region, requested this review to evaluate complaints made by 3d-----regarding the treatment of taxpayers during a Regional Compliance Program (RCP) project in the North Florida District. In RCP projects, the Internal Revenue Service (IRS) makes an effort to contact taxpayers about their tax compliance without reviewing books or records. These compliance checks should not question any particular tax liability. Allegedly, revenue officers used unauthorized techniques to work RCP project leads on employment tax issues in the construction trades industry.

The IRS Acting District Director, North Florida District, and the Assistant Commissioner (Examination), each responded to members of the Congress concerning these complaints, stating that revenue officers in the RCP group were all working in accordance with IRS policies and procedures, and that the revenue officers received training specific to their involvement in the project. According to Collection Division information, the RCP group closed 664 cases before the project was discontinued. These cases resulted in 1,554 returns filed with revenue officers and net assessments of approximately \$6 million.

The overall objective of this audit was to determine if taxpayer rights were violated by the manner in which employment tax cases were worked during the period October 1993 through September 1995.

Results

Our opinions and conclusions are different from the opinions and conclusions that Collection Division management communicated to the Congress. (See Appendices V through VII for responses to the Congress.)

It appears that taxpayers were treated inconsistently because two sets of procedures were used to work RCP employment tax leads.

During the time period of the RCP project in the North Florida District, two Collection Division groups were working employment tax leads using different procedures. The Employment Tax Examination Group followed the procedures established by the Collection Division for employment tax examinations while the RCP group used locally developed procedures. The local procedures allowed revenue officers to make employment tax determinations without requiring them to follow the procedures in the

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Internal Revenue Manual (IRM) 5(10) for investigating employment tax issues. This environment placed the taxpayers' right to fair treatment at risk.

We were unable to determine whether the taxpayers' right to pay only the correct amount of tax was violated without re-examining the taxpayers' returns. In 43 percent of the cases reviewed, the case documentation and history sheets did not document the basis for decisions made by the revenue officers. As a result of this lack of documentation, an independent reviewer could not have determined from the case files whether the revenue officers properly developed the cases and correctly applied the laws and regulations related to employment taxes.

Collection Division Expanded Compliance Checks into Examinations Without Following the Appropriate Procedures

- Revenue officers did not notify the taxpayers orally or in writing when compliance checks were expanded into employment tax examinations. Also, revenue officers did not provide the taxpayers with an explanation of the audit process.
- Collection Division management did not control and monitor the RCP cases on the Audit Information Management System (AIMS) when the compliance checks were expanded into employment tax examinations. As a result, no indicators were present on IRS' computer system that audits were conducted.
- Revenue officers in the RCP group did not prepare workpapers documenting the scope of the examinations, the procedures followed, or the conclusions reached.

Collection Division Management Did Not Ensure that Revenue Officers Working RCP Project Employment Tax Leads Followed the Established IRM Procedures for Employment Tax Examinations

As a result of management not ensuring that revenue officers working the RCP project followed IRM 5(10), locally developed procedures used during the project were inconsistent with the IRM and the following provisions were not consistently and properly applied:

- Section 530 of the Revenue Act of 1978 – Provides businesses with relief from employment tax obligations if certain requirements are met.
- Internal Revenue Code Section 3509 – Allows taxpayers reduced rates for computing employment taxes in worker reclassification cases.
- Internal Revenue Code Section 6020(b) – Provides authority for employment tax returns to be prepared by the IRS in cases of refusal to file.

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Collection Division Management Did Not Provide Sufficient Training to the Revenue Officers Assigned to the RCP Project

The revenue officers that worked the RCP project cases received one day of training, while revenue officer examiners in the Employment Tax Examination Group received the standard 64-hour training course, Basic Employment Tax Training (Course 3142). A regional analyst and a District employment tax staff member informed us that the cases investigated during the RCP project would have been worked differently if they had been assigned to Collection Division employment tax examiners or the Examination Division.

The Regional Office Visited the District in September 1996 to Review the RCP Project, but Did Not Prepare a Written Report.

We could not determine whether the Region identified any of the previously stated issues because its representatives did not prepare a written report of their visit. However, the Regional Chief Compliance Officer did ask Regional Counsel for an opinion regarding revenue officer authority on employment tax issues. In October 1996, Regional Counsel issued a memorandum to the Regional Chief Compliance Officer stating that revenue officers can reclassify workers pursuant to the authority given them in their position description.

We interviewed Regional Counsel and determined that Counsel was ruling only on the legality of the assessments. Counsel stated in their discussion with auditors that the assessments are legal based on the broad position description of the revenue officers. The opinion was not intended to imply that they thought the revenue officers were adequately trained, or that the correct procedures were followed.

Management's Response: Collection Division management agreed that during the time period of the RCP project, there were two groups working employment tax leads using different procedures. They also agreed that sufficient training had not been provided to the revenue officers assigned to the RCP project. Since the project was terminated in September 1995, there are no required corrective actions for these three findings. However, management agreed to an independent review of project files by employment tax examiners to determine whether taxpayers were treated inconsistently. This review began in January 1999. When necessary, management will contact Counsel to determine any remedial actions that must take place for affected taxpayers.

Management's complete response detailing corrective actions, responsible officials, and proposed completion dates is contained in Appendix VIII.

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Objective and Scope

The Regional Commissioner requested that TIGTA evaluate complaints made by 3d----- 3d-----that revenue officers used unauthorized techniques to work RCP project leads on employment tax issues.

Our objective was to determine if taxpayer rights were violated.

We initiated this limited scope review at the request of the Regional Commissioner, Southeast Region. He requested that the Treasury Inspector General for Tax Administration (TIGTA) (formerly the Inspection Service) evaluate complaints made by 3d----- 3d-----concerning revenue officers in the North Florida District. 3d-----alleged that revenue officers used unauthorized techniques to work Regional Compliance Program (RCP) project leads on employment tax issues in the construction trades industry.

Our field work was performed during the period March 1998 through July 1998, in the North Florida District. This audit was performed in accordance with *Government Auditing Standards*.

The overall objective of this audit was to determine if taxpayer rights were violated by the manner in which employment tax cases were worked in the RCP project in the North Florida District from October 1993 until September 1995. To accomplish this objective, we:

- Performed research to identify the appropriate guidance for conducting RCP projects and for working employment tax leads.
- Reviewed closed RCP project cases to determine if the cases worked reflect evidence that procedures were followed and taxpayer rights were protected. We reviewed 267 cases where employment tax was an issue and the revenue officer either used Internal Revenue Code (IRC) section 6020(b) procedures or the taxpayer agreed to a conversion. IRC 6020(b) provides the Internal Revenue Service (IRS) with the authority to prepare employment tax returns in cases where the taxpayer refuses to file. We determined whether the following were properly considered:

◇ Section 530 of the Revenue Act of 1978.

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- ◇ Revenue Ruling 87-41.
- ◇ IRC Sections 3509 and/or 3402(d).
- ◇ IRC Section 6020(b).
- Interviewed District Collection Division managers and revenue officers concerning the process/procedures used in the RCP project.
- Reviewed the actions taken by the Region to investigate the complaints made by 3d-----
3d-----as they relate to the RCP project and the taxpayers involved.

Appendix I presents our detailed objectives, scope, and methodology. Appendix II provides a listing of the major contributors to this report.

Background

The RCP project was approved in October 1993, and was designed primarily to improve compliance with employment taxes in the construction trades industry.

In August 1993, the former District Director, North Florida District, requested approval to conduct a local RCP project designed to improve compliance with employment taxes within the construction trades industry. The Southeast Region approved the project in October 1993. The project methodology was based on obtaining lists of sub-contractors from general contractors. Project coordinators screened the lists of sub-contractors on the Integrated Data Retrieval System (IDRS) to determine if the sub-contractors' returns were in compliance with the employment tax laws. If the sub-contractor had not filed a return, the case was assigned to a revenue officer. The project focused on the sub-contractors' filing of required income and employment tax returns, the accuracy of reporting gross receipts, and the proper classification of workers for employment tax purposes. The project's objective was to "level the playing field" for sub-contractors, enabling all sub-contractors to be competitive in bidding for contracts without resorting to noncompliance with the federal tax laws.

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In February 1995, the project was temporarily suspended pending clarification of compliance checks and examinations.

The project was temporarily suspended in February 1995, pending clarification from the Region regarding compliance checks and examinations. Also at that time, the District was responding to concerns raised by 3d-----regarding the project and the treatment of taxpayers. The 3d-----3d-----concerns were that revenue officers:

- Ignored Section 530 of the Revenue Act of 1978, which can relieve a business of employment tax obligations if the business has a reasonable basis for not treating workers as employees, has been consistent in its treatment of any similar workers as contractors, and has been consistent in filing required information returns.
- Ignored Revenue Ruling 87-41, which provides guidance concerning the factors that are used to determine if an employment relationship exists.
- Did not consider IRC Sections 3509 and/or 3402(d), which can reduce the amount of tax assessed.
- Did not have the authority to work employment tax issues.
- Used extortion tactics to coerce taxpayers into agreeing to reclassify workers from independent contractors to employees.

The project was re-started in April 1995 and discontinued in September 1995, due to policy changing directives from National Office.

The project was started again in April 1995, and discontinued in September 1995. According to documentation obtained from the District, the decision to discontinue the project was primarily due to the issuance of new policy directives from the National Office, which indicated that 2b, 2e-----2b, 2e----- Collection Division information shows that the RCP group closed 664 cases before the project was discontinued. These cases resulted in 1,554 returns filed with revenue officers and net assessments of approximately \$6 million.

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The Region conducted a review of the RCP project and requested an advisory opinion from Regional Counsel regarding revenue officer authority on employment tax issues.

In July 1996, the District requested that the Region review the RCP project to assess the District's compliance with the Internal Revenue Manual (IRM) and the IRC. As a result, the Region wrote a plan in September 1996 to review the project and conducted interviews with District management and revenue officers. The Region also requested an advisory opinion from Regional Counsel regarding revenue officer authority on employment tax issues. The Chief Compliance Officer briefed the District Director verbally on the results of their review.

Results

It appears that taxpayers were treated inconsistently.

Based on our review of the RCP project for the North Florida District construction trades industry, it appears that taxpayers may have been treated inconsistently because of the manner in which employment tax leads were worked.

Our opinions and conclusions in this report are different from the opinions and conclusions of IRS management that were previously communicated to members of the Congress. See Appendices V through VII for the IRS responses to the Congress.

Two Collection groups were working employment tax leads using different procedures.

From October 1993 until September 1995, the North Florida District had two Collection groups working employment tax leads using different procedures. The Employment Tax Examination Group followed IRM 5(10) (Employment Tax Examinations), and the RCP group used locally developed guidelines. The local procedures allowed revenue officers to make employment tax determinations without requiring them to follow the procedures in IRM 5(10) for investigating employment tax issues. This environment placed the taxpayers' right to fair treatment at risk.

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We were unable to determine whether the taxpayers' right to pay only the correct amount of tax was violated without re-examining the taxpayers' returns.

The case documentation and history sheets did not always document the basis for decisions made by revenue officers. Therefore, without re-examining the taxpayers' returns, we were unable to determine whether the taxpayers' right to pay only the correct amount of tax was violated.

The results of our review show that Collection Division management did not:

- Ensure that appropriate procedures were followed by the revenue officers working the RCP project when compliance checks were expanded into examinations.
- Ensure that revenue officers working RCP project employment tax leads followed the established IRM procedures for employment tax examinations.
- Provide sufficient training to the revenue officers assigned to the RCP project.

The Region did not prepare a written report of its review. However, they obtained an opinion from Regional Counsel, stating that revenue officers have the authority in their position description to reclassify workers.

The Region did not prepare a written report of its review of this project; therefore, we could not determine whether it identified these issues. The Region did ask Regional Counsel for an opinion regarding revenue officer authority on employment tax issues. In October 1996, Regional Counsel issued a memorandum to the Chief Compliance Officer, Southeast Region, stating that revenue officers can reclassify workers pursuant to the authority given them in their position description.

We interviewed Regional Counsel and determined Counsel was ruling only on the legality of the assessments.

We interviewed Regional Counsel and determined that they were ruling only on the legality of the assessments. Counsel stated in their discussion with auditors that the assessments are legal based on the broad position description of the revenue officers. The opinion was not intended to imply that Counsel thought the revenue officers were adequately trained, or that the correct procedures were followed.

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**Collection Division Expanded Compliance
Checks into Examinations Without Following the
Appropriate Procedures**

The RCP project concentrated on the proper classification of workers. However, we found that revenue officers conducted examinations and did not notify the taxpayers who were being examined.

The RCP project primarily concentrated on unfiled income tax returns and the proper classification of construction workers. The revenue officers received compliance leads to follow up with the taxpayers to resolve any issues regarding their compliance with the tax laws. However, we found that in determining the classification of workers, the revenue officers actually conducted employment tax examinations and did not notify the taxpayers that they were being examined. In fact, the taxpayers were informed in the initial contact letters that these contacts were for compliance checks rather than examinations.

Revenue officers were making determinations as to the taxpayers' liabilities for employment taxes.

Based on our review of 267 closed RCP project cases, the revenue officers were making determinations as to the taxpayers' liabilities for employment taxes. In 198 of the 267 cases, the revenue officers made determinations to reclassify workers from independent contractors to employees. Our review of the cases and interviews with the revenue officers showed the following:

- In 51 of 267 cases, the history sheets documented that the 20 common law questions, which are routinely used during IRS examinations to determine worker classification issues, were discussed with the taxpayers in order to make a determination as to their liability for employment taxes.
- In 15 of 267 cases, the taxpayers' books and records were reviewed by revenue officers. In RCPs, the revenue officers should limit their review to IRS documents that have already been voluntarily supplied to the IRS. However, the books and records requested and reviewed in these cases included, but were not limited to, worker's compensation insurance certificates, occupational licenses, and job contracts.

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- In 114 of 267 cases, the history sheets and documentation did not support the basis for converting the taxpayers' workers from independent contractors to employees. In our interviews with 10 revenue officers who worked cases in the RCP project, 5 stated that they were not clear on when their actions constituted examinations. However, the majority of the revenue officers said they used the 20 common law questions to determine if the taxpayers needed to convert their workers to independent contractors.
- The remaining 87 cases were closed as returns secured/previously filed, Section 530 safe havens, transfers, or referrals to Examination and/or the Employment Tax Examination Group.

Discussing the 20 common law factors and reviewing books and records constitutes an examination. Full compliance checks do not include discussing the 20 common law questions.

We believe discussing the 20 common law factors and reviewing a taxpayer's books and records constitutes an examination and not a compliance check. According to the Collection Handbook (IRM 5(10)22.1(4)), an examination should be opened if a revenue officer examiner cannot bring the taxpayer into compliance at the initial interview without reviewing the books or records or asking the 20 common law questions. Full compliance checks do not include discussing the 20 common law questions.

Taxpayers Were Not Notified They Were Being Examined

The taxpayers should have been notified orally and in writing when the compliance checks were expanded into employment tax audits.

At the time the compliance checks were expanded to include reviews of the books and records, and discussions of the 20 common law factors, the taxpayers should have been notified orally and in writing that the compliance checks were expanded into employment tax audits.

Taxpayers have the right to know the IRS audit process any time they are interviewed regarding the determination of any tax. In the RCP group, revenue officers were contacting taxpayers and asking questions

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leading to tax determinations, but were not aware of the audit process and did not follow the Collection Handbook for Employment Tax Examinations.

The revenue officers did not provide the taxpayers an explanation of the audit process because the revenue officers did not know they were conducting examinations.

The revenue officers did not provide the taxpayers with an explanation of the audit process as explained in the IRC and the Collection Handbook because the revenue officers did not know they were conducting examinations. These revenue officers did not know they were conducting examinations because they were not adequately trained or instructed to follow the provisions of the Collection Handbook for Employment Tax Examinations.

Examinations Were Not Controlled on the Audit Information Management System

The revenue officers were conducting employment tax examinations, but management did not ensure these cases were controlled and monitored on AIMS.

The revenue officers were conducting employment tax examinations, but management did not ensure these examinations were controlled and monitored on the Audit Information Management System (AIMS). AIMS is an inventory system used to track open examination cases, which includes Collection employment tax examinations. Because Collection management did not establish the cases on AIMS, they were unable to track the location, age, or status of the open cases. This lack of control increased the risk for statutes to expire. Also, there were no audit indicators on the Master File (the IRS' main tracking system) to indicate that the taxpayers were audited. This could have affected the taxpayers' rights, as they pertain to unnecessary examinations. According to IRC Section 7605(b), only one inspection of a taxpayer's books of account should be made for each taxable year.

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**Adequate Supporting Workpapers Were Not
Prepared**

Workpapers were not prepared documenting the scope of the examinations, the procedures followed, or the conclusions reached.

Workpapers prepared by the revenue officers in the RCP group did not contain documentation for the scope of the examinations, the procedures followed, or the conclusions reached. The RCP project case files primarily consisted of the revenue officers' history sheets, copies of returns secured or prepared, and copies of items such as worker's compensation certificates, job contracts, and cancelled checks.

An independent reviewer could not have determined from the case files whether the revenue officers properly developed the cases and/or correctly applied the laws and regulations.

In 114 of 267 cases (43 percent), the history sheets lacked documentation necessary for an independent reviewer to be able to concur with the revenue officers' decisions on whether to convert independent contractors to employees. An independent reviewer could not have determined from the case files whether the revenue officers properly developed the cases and/or correctly applied the laws and regulations related to employment taxes.

Management's Response: Collection Division management agreed that during the time of the RCP project, there were two groups working employment tax leads using different procedures. Management agreed that an independent review of project files be conducted by employment tax examiners to address whether or not taxpayers were treated inconsistently. This review began in January 1999. When necessary, Counsel will be contacted to determine any remedial actions for those taxpayers who are identified as having received inconsistent treatment.

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**Collection Division Management Did Not Ensure
that Revenue Officers Working RCP Project
Employment Tax Leads Followed the
Established IRM Procedures for Employment
Tax Examinations**

The IRS has established procedures for the Collection Employment Tax Examination Program. At the time of the RCP project, the North Florida District Collection Division had a dedicated employment tax group staffed with trained revenue officer examiners. This group used the procedures in IRM 5(10) for investigating employment tax issues. We interviewed two revenue officer examiners and the group manager concerning their procedures; however, we did not review any cases for this group.

Revenue officers in the RCP group were not instructed to follow the employment tax procedures in IRM 5(10).

In contrast, the RCP group was comprised of revenue officers who investigated employment tax leads, but were not instructed to follow the procedures in IRM 5(10). This group had locally developed procedures that were inconsistent with IRM 5(10). As a result of management not instructing revenue officers to comply with IRM 5(10), the following provisions were not consistently and properly applied:

- Section 530 of the Revenue Act of 1978.
- IRC Section 3509 - Determination of Employer's Liability.
- IRC Section 6020(b) - Returns prepared by the IRS in cases of refusal to file.

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**Proper Consideration Was Not Given to
Section 530 of the Revenue Act of 1978**

The Congress enacted Section 530 of the Revenue Act of 1978 as a result of controversies between the IRS and taxpayers concerning the proper classification of workers.

The IRS' enforcement of the employment tax laws resulted in many controversies between the IRS and taxpayers concerning the proper classification of workers. As a result of these controversies, the Congress enacted Section 530 of the Revenue Act of 1978. Section 530 provides businesses with relief from Federal employment tax obligations if certain requirements are met. The relief requirements are reasonable basis, substantive consistency, and reporting consistency. To establish reasonable cause for relief, the taxpayers must show the following:

- 1) they relied on a court case or ruling issued by the IRS; or
- 2) their business was audited by the IRS at a time when they treated similar workers as independent contractors, and the IRS did not reclassify those workers or employees; or
- 3) they treated the workers as independent contractors because that was how a significant segment of the industry treated similar workers; or
- 4) they relied on some other reasonable basis, such as the advice of a business lawyer or accountant.

A taxpayer should be provided a Section 530 letter prior to an examination.

According to the Collection Handbook, a Section 530 letter should be provided to the taxpayer before an examination begins. The examiner does not have to develop the basis for the taxpayer, but merely has to advise the taxpayer of the provisions under Section 530.

Case documentation did not reflect whether Section 530 was discussed in 39 of the 42 cases that have a prior audit indicator for periods after tax year 1980.

Documentation supplied by the District provided that the RCP project would deal with Section 530 on a case-by-case basis, if and when the issue was raised by the taxpayers. We did not identify any cases where Section 530 letters were provided to the taxpayers. In addition, we identified 42 cases with prior audit

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indicators for periods after tax year 1980. The case documentation did not reflect whether Section 530 was considered in 39 of the 42 cases. The only mention of Section 530 in the case files was when the taxpayers or their representatives raised the issue. For example:

- One taxpayer had a previous audit (1986) that he brought to the revenue officer's attention at their first meeting. The revenue officer believed the prior audit might create a Section 530 safe haven. However, after further examination of the taxpayer, the revenue officer determined the control element over sub-contractors was evident and the sub-contractors were probably employees. The revenue officer told the taxpayer to convert his workers to employees and warned the taxpayer that IRC Section 6020(b) would be used for six years, and that the taxpayer would also be referred to Examination if he did not convert the employees. Nonetheless, after the taxpayer provided the revenue officer with the 1986 examination results, the revenue officer reconsidered his position and the case was closed as a Section 530 safe haven.
- Another taxpayer raised the Section 530 safe haven issue based upon industry practice for carpet installers. The taxpayer had researched the industry and was aware of the IRS' lack of success regarding employment taxes in the carpet installers industry. However, the revenue officer still tried to get the taxpayer to convert his workers to employees. This case was closed as a Section 530 safe haven.

Proper Consideration Was Not Given to IRC Section 3509

*Reduced rates under IRC
Section 3509 generally were
either not allowed or
inconsistently applied.*

In general, IRC Section 3509 rates were either not allowed or were inconsistently applied. IRC Section 3509 provides special procedures for determining an employer's liability for employee Federal Insurance Contribution Act (FICA) tax and income tax

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withholding in the case of worker reclassification. Under IRC Section 3509, withheld income taxes and social security taxes are computed using reduced rates.

Taxpayers are still eligible for IRC Section 3509 rates if they have not filed Forms 1099.

According to the IRC, taxpayers who do not file Information Returns (Form 1099) are still eligible for reduced rates unless they intentionally disregard the requirement to withhold FICA and income tax. According to the IRC, examples of intentional disregard are as follows:

- Reclassifying certain employees as independent contractors while others are continuing to do the same job as employees.
- Failing to treat a class of workers as employees after a determination letter is issued.
- Disregarding the employment tax laws in years after an audit for the same class of worker.

Our review identified 19 additional taxpayers who should have received reduced tax rates under IRC Section 3509.

Of the 198 cases where workers were converted from independent contractors to employees, 65 received reduced rates under IRC Section 3509. Based on our review of the cases, another 19 taxpayers should have received reduced rates under IRC Section 3509. Collection Division management disagreed with our opinion on 11 of the 19. The Collection Division stated that the taxpayers either did not file Forms 1099 or they intentionally disregarded requirements to withhold FICA and income taxes. However, this is inconsistent with Collection Division management's actions during the RCP project. For example, Collection Division management allowed IRC Section 3509 rates to 21 taxpayers who did not file Forms 1099. These 21 taxpayers were allowed IRC Section 3509 rates under similar circumstances as the 19 taxpayers that were denied IRC Section 3509 rates.

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**Proper Consideration Was Not Given in the Use
of IRC Section 6020(b)**

Prior and subsequent to the RCP project, referrals should have been made to the Revenue Officer Examination Program when employer/employee relationship problems existed.

The Collection Handbook for Delinquent Return Procedures states that if the investigating officer determines there is an employer/employee relationship problem, a referral will be made to the District Revenue Officer Examination Program. Some of the revenue officers who participated in the RCP project said that prior to and after the project, they would not have tried to make the employer/employee determinations themselves. They would have referred those issues to the Collection Employment Tax Examination Group instead of trying to make the determinations themselves.

We believe the taxpayers opted to convert their workers to employees and file one or two quarters of Forms 941 because it was their least costly option.

Approximately 35 percent of the taxpayers who converted their workers were told that if they did not voluntarily convert their workers and file one or two quarters of Forms 941 (Employer's Quarterly Federal Tax Return), the revenue officers would prepare returns using IRC Section 6020(b) procedures. We believe a large number of these taxpayers agreed to convert, whether they agreed with the revenue officers' position or not, because it was the least costly option for the taxpayers. For example:

- A taxpayer received a letter from a revenue officer stating that, in exchange for voluntary conversion, the taxpayer could file a Form 941 for one quarter using IRC Section 3509 rates and no penalties would be assessed. However, if the taxpayer chose not to voluntarily convert, Forms 940 (Employer's Annual Federal Unemployment Tax Return) and 941 would be prepared beginning with the date of incorporation (June 1990) and continuing until the present time (July 1994). The returns would be assessed using the full FICA rate and an estimated 20 percent of wages as withholding tax. In addition, all penalties and interest would be assessed.

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Revenue officers and employment tax personnel stated that IRC Section 6020(b) procedures are not appropriate if the taxpayers file Forms 1099 on their workers.

We discussed the use of IRC Section 6020(b) procedures with the revenue officers who participated in the RCP project and personnel assigned to the Collection Employment Tax Examination Group. They stated that IRC Section 6020(b) procedures are not appropriate if the taxpayers are treating their workers as independent contractors and filing Forms 1099. IRC Section 6020(b) procedures were used in only 14 of the 267 cases where the taxpayers refused to voluntarily convert. Of the 14 times IRC Section 6020(b) procedures were used, 8 taxpayers had their assessments partially or entirely abated. One taxpayer appealed 10 quarters of Section 6020(b) assessment proposals and agreed to a settlement of treating workers as employees in the future.

Management's Response: Collection Division management agreed that there were two groups working the RCP and they were using different procedures. Management has agreed to an independent review of project files by employment tax examiners to determine whether taxpayers were treated inconsistently. This review began in January 1999. If the independent review shows inconsistent treatment of taxpayers, the Collection Division will contact Counsel to determine any remedial action that must be taken.

Collection Division Management Did Not Provide Sufficient Training to the Revenue Officers Assigned to the RCP Project

Revenue officers did not receive the minimum 64 hours training prior to working employment tax leads.

Revenue officers were not provided adequate training to make employment tax determinations. The revenue officers who worked the RCP project cases received one day of training. However, revenue officer examiners in the Employment Tax Examination Group received the standard 64-hour training class, Basic Employment Tax Training, prior to working employment tax issues.

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Based on documentation provided by Collection Division management, revenue officer training for the RCP project was designed to avoid in-depth discussions of Section 530 and IRC Section 3509, which are common issues for employment tax determinations. Additionally, revenue officers who participated in the project expressed their concerns to the Region and our auditors about the adequacy of the training provided by the District.

Revenue officers we interviewed felt the training provided was not adequate.

We interviewed 10 revenue officers who worked cases in the project, and they generally believed that the training was not adequate for what they were asked to do. In addition, the Region interviewed four revenue officers who agreed the training was not adequate. The IRS also received an anonymous letter on September 30, 1993, from a revenue officer who said he/she did not feel adequately trained to do the job he/she was instructed to do. The letter cited that IRC Section 3509 and Section 530 were mentioned but not explained during training.

Five of the 10 revenue officers did not know what constituted an audit.

Five of the 10 revenue officers did not know what constituted an examination of taxpayer books, records, and the associated financial information to determine the correct tax liability. Some felt they were doing the same thing as the Employment Tax Examination Group. Others believed the difference between themselves and the revenue officer examiners was that the revenue officer examiners had to go into more depth on the 20 common law questions and the IRC. (See Appendix IV for an explanation of the 20 common law factors.) Revenue officer examiners also had to document the issues and the applicable laws, regulations, and/or court decisions to support their position. In addition, three of the revenue officers interviewed by the Region felt they were doing examinations instead of compliance checks.

RCP project cases would have been worked differently by the Collection Employment Tax Examination Group according to Regional and District personnel.

A regional analyst and a District employment tax staff member informed us that the cases investigated during the RCP project would have been worked differently if they had been assigned to Collection employment tax examiners or the Examination Division. These groups have more expertise and training with

Internal Revenue Service Procedures Were Not Consistently Followed When North Florida District Revenue Officers Attempted to Improve Tax Compliance in the Construction Trades Industry

Guidelines require employment tax cases to be worked by persons who are adequately trained.

employment tax issues, such as Section 530, Revenue Ruling 87-41 (20 Common Law Factors), and IRC Sections 3509 and 3402(d).

The examination and review of employment tax cases should be performed by individuals who have adequate technical training and experience. Each District Collection Division is responsible for providing adequate employment tax training. We were unable to determine from the documentation provided the reason the revenue officers assigned to the RCP project were not provided the standard 64-hour training course.

Management's Response: Collection Division management agreed that sufficient training was not provided to the revenue officers assigned to the RCP project. Since the project was terminated in September 1995, there is no required corrective action.

Conclusion

It appears that taxpayers were treated inconsistently because of the manner in which RCP employment tax leads were worked.

It appears that taxpayers were treated inconsistently because two sets of procedures were used to work RCP employment tax leads. During the time period of the RCP project in the North Florida District, two Collection groups were working employment tax leads using different procedures.

The Employment Tax Examination Group followed procedures established by the Collection Division for employment tax examinations, and the RCP group used locally developed procedures. The local procedures allowed revenue officers to make employment tax determinations without requiring them to follow the procedures in IRM 5(10) for investigating employment tax issues. This environment placed the taxpayers' right to fair treatment at risk, which includes their right to know the audit process when being interviewed as to a tax determination, and their right to relief from unnecessary examinations.

**Internal Revenue Service Procedures Were Not Consistently Followed
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Appendix I

Detailed Objective, Scope and Methodology

The overall objective of this audit was to determine whether taxpayer rights were violated because of the manner in which employment tax cases were worked in the Regional Compliance Program (RCP) in the North Florida District (formerly known as the Jacksonville District) from October 1993 until September 1995.

- I. To determine if the procedures used by the North Florida District for working employment tax cases provided protection of taxpayer rights, we:
 - A. Defined guidance using the following:
 - 1. Internal Revenue Code (IRC).
 - 2. Internal Revenue Manual (IRM), Part V, Collection.
 - 3. IRM, Part VI, Examination.
 - 4. Regional Counsel.
 - 5. Taxpayer Bill of Rights.
 - B. Determined if there were inconsistencies between the guidance and the actions taken by the District in working the RCP. Where inconsistencies were identified, we determined if the actions violated taxpayer rights.
 - C. Interviewed Regional Counsel to determine if they agreed with our conclusion regarding procedures versus basic taxpayer rights.
 - D. Interviewed District managers and revenue officers associated with the RCP concerning the process/procedures used in the RCP. Coordinated with Investigations prior to conducting the interviews.
 - E. Interviewed 3d-----concerning 3d-allegations and ----contacts with the IRS as they relate to the RCP. Coordinated with Investigations prior to conducting the interview.
 - F. Reviewed the actions taken by the Region to investigate the complaints made by 3d-----as they relate to the RCP and the taxpayers involved.
 - G. Determined if the Region reviewed any other RCP for employment taxes. If so, completed the following:
 - 1. Identified the RCP project and the District where it was worked.
 - 2. Obtained and reviewed the results of the Region's review.

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- II. To determine whether the cases worked in the RCP reflect evidence that taxpayer rights were violated, we:
- A. Obtained the complete database of all cases worked in the RCP and determined the following:
 - 1. Number of leads.
 - 2. Number of case closures.
 - 3. Total dollars assessed.
 - 4. Total dollars collected.
 - 5. Total returns secured by type (Master File Tax Code).
 - 6. Revenue officers assigned any of the leads/cases and the number of cases worked by revenue officer.
 - B. Stratified the data by types of closure as follows:
 - 1. IRC Section 6020(b).
 - 2. Returns secured where the taxpayer agreed to convert independent contractors to employees.
 - 3. No change.
 - 4. Not Liable/Returns Previously Filed/Invalid Lead, etc.
 - C. For the cases where returns were filed using IRC Section 6020(b) procedures or returns were secured for a conversion, obtained a bulk Master File transcript extract to determine the following:
 - 1. Subsequent appeals.
 - 2. Examination indicators.
 - 3. Claims filed.
 - 4. Business life span, last quarter returns filed (Forms 940, 941, 1120, 1065).
 - 5. Account status (full paid, balance due, currently uncollectible, etc.).
 - 6. Subsequent abatements of employment tax assessments.
 - D. Obtained a judgmental sample of the case files and evaluated the documentation in the case file to determine how the cases were worked.
 - 1. Determined whether the following were considered:
 - a) Section 530 of the Revenue Act of 1978.

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- b) Revenue Ruling 87-41.
 - c) IRC Sections 3509 and/or 3402(d).
- 2. Identified instances where it appeared the taxpayer was coerced into agreeing to a conversion.
- 3. Reviewed the taxpayer account history for evidence of events not within the defined procedures.
- 4. Determined if the taxpayer had an audit prior to this compliance check for purposes of Section 530 of the Revenue Act of 1978. Ordered Retention Modules for all sample cases to review for examination indicators.
- 5. Where insufficient documentation exists, considered taxpayer interviews. Coordinated with Investigations.

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Appendix II

Major Contributors to This Report

M. Susan Boehmer, Acting Regional Inspector General for Audit

Thomas H. Black, Audit Manager

LuAnn Finkelstein, Senior Auditor

Jeffrey Aldridge, Auditor

Pat Goodrich, Auditor

Robert Leeke, Auditor

James Mills, Auditor

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Appendix III

Report Distribution List

Deputy Commissioner for Operations C:DO
National Taxpayer Advocate C:TA
Chief Operations Officer OP
Assistant Commissioner (Collection) OP:CO
Assistant Commissioner (Examination) OP:EX
Assistant Commissioner (Program Evaluation and Risk Analysis) M:OP
Chief Counsel CC
National Director for Legislative Affairs CL:LA
Office of Management Controls M:CFO:A:M
Regional Commissioner
Regional Chief Compliance Officer RCCO - SER
Regional Chief Counsel - SER
Regional Appeals Officer - SER
District Director – North Florida
Office of Audit Liaisons:
 AC (Collection) CP:CO:C:IE
 Taxpayer Advocate C:A
 Regional Controller (IA Liaison)
 District Audit Coordinator – North Florida

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Appendix IV

**Revenue Ruling 87-41
20 Common Law Factors**

To help taxpayers determine whether an individual is an employee under the common law rules, the Internal Revenue Service (IRS) has identified 20 factors, which are used as guidelines to determine whether sufficient control is present to establish an employer-employee relationship.

These factors should be considered guidelines. Not every factor is applicable in every situation, and the degree of importance of each factor varies depending on the type of work and individual circumstances. However, all relevant factors are considered in making a determination, and no one factor is decisive. It does not matter that a written agreement may take a position with regard to any factors or state that certain factors do not apply, if the facts indicate otherwise. The 20 factors indicating whether an individual is an employee or an independent contractor are:

- 1) ***Instructions.*** An employee must comply with instructions about when, where, and how to work. Even if no instructions are given, the control factor is present if the employer has the right to control how the work results are achieved.
- 2) ***Training.*** An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods and receive no training from the purchasers of their services.
- 3) ***Integration.*** An employee's services are usually integrated into the business operations because the services are important to the success or continuation of the business. This shows that the employee is subject to direction and control.
- 4) ***Services Rendered Personally.*** An employee renders services personally. This shows that the employer is personally interested in the methods as well as the results.
- 5) ***Hiring Assistants.*** An employee works for an employer who hires, supervises, and pays workers. An independent contractor can hire, supervise, and pay assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.
- 6) ***Continuing relationship.*** An employee generally has a continuing relationship with an employer. A continuing relationship may exist even if work is performed at recurring although irregular intervals.

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- 7) ***Set hours of work.*** An employee usually has set hours of work established by an employer. An independent contractor generally can set his or her own work hours.
- 8) ***Full-time required.*** An employee may be required to work or be available full-time. This indicates control by the employer. An independent contractor can work when and for whom he or she chooses.
- 9) ***Work done on premises.*** An employee usually works on the premises of an employer, or works on a route or at a location designated by an employer.
- 10) ***Order or sequence set.*** An employee may be required to perform services in the order or sequence set by an employer. This shows that the employee is subject to direction and control.
- 11) ***Reports.*** An employee may be required to submit reports to an employer. This shows that the employer maintains a degree of control.
- 12) ***Payments.*** An employee is paid by the hour, week, or month. An independent contractor is usually paid by the job or on a straight commission.
- 13) ***Expenses.*** An employee's business and travel expenses are generally paid by an employer. This shows that the employee is subject to regulation and control.
- 14) ***Tools and materials.*** An employee is normally furnished significant tools, materials, and other equipment by an employer.
- 15) ***Investment.*** An independent contractor has a significant investment in the facilities he or she uses in performing services for someone else.
- 16) ***Profit or loss.*** An independent contractor can make a profit or suffer a loss.
- 17) ***Works for more than one person or firm.*** An independent contractor is generally free to provide his or her services to two or more unrelated persons or firms at the same time.
- 18) ***Offers services to general public.*** An independent contractor makes his or her services available to the general public.
- 19) ***Right to fire.*** An employee can be fired by an employer. An independent contractor cannot be fired so long as he or she produces a result that meets the specifications of the contract.
- 20) ***Right to quit.*** An employee can quit his or her job at any time without incurring liability. An independent contractor usually agrees to complete a specific job and is responsible for its satisfactory completion, or is legally obligated to make good for failure to complete it.

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Appendix V

Internal Revenue Service

Department of the Treasury

District
Director

P. O. Box 35045, Jacksonville, FL 32202

JUN 14 1995

The Honorable Tillie K. Fowler
Member of Congress
4452 Hendricks Avenue
Jacksonville, FL 32207

Person to Contact:
W. Smith
Telephone Number:
(904) 232-2046
Refer Reply to:
Stop: 5760
Date:

JUN 13 1995

Dear Ms. Fowler:

This is in response to your letter of March 28, 1995, on behalf of your constituent, [redacted] which was directed to Ms. Anne Raffaelli, Director of Legislative Affairs. Your correspondence was forwarded to this office for reply since the Returns Compliance Programs (RCP) referenced by [redacted] were Jacksonville District programs. We apologize for the delay in our response.

Our Chief, Collection Division, Chief, Special Procedures function, and Group Manager in charge of the Construction Trades Returns Compliance Program met with [redacted] on 12/22/94 to discuss [redacted] concerns. The issues raised in that meeting mirror those in [redacted] correspondence to you. [redacted] review of the programs following that meeting indicated that the programs were being conducted in accordance with established Internal Revenue Service policies and procedures.

Assignments in both programs have generally been worked by our higher graded and more experienced revenue officers. All of the revenue officers involved in the programs have received training specific to their involvement in the programs. All of the actions performed by revenue officers in either of the subject RCPs were authorized actions consistent with duties and responsibilities outlined in their standard position descriptions.

The Construction Trades RCP was initiated based in part upon the recommendations of our field personnel who were observing significant compliance problems in the construction industry. It was also based upon communication from taxpayers who told us that they were having significant problems in competing for business in the industry due to being unfairly underbid by those who were not paying taxes. Our initial compliance testing and subsequent experience in the program confirmed that a significant compliance problem existed in the industry. The problem included failure to file both individual and business related returns, misclassification of employees as self-employed contractors, failure to issue information documents reporting wages and other remuneration paid, etc.

Media publicity was generated to announce the RCPs and provide an opportunity to those taxpayers who wished to voluntarily comply.

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-2-

The Honorable Tillie K. Fowler

Taxpayers were then contacted by correspondence which provided additional opportunity for voluntary compliance, offered assistance with filing and paying of returns, and provided Publication 1, "Your Rights as a Taxpayer." Our experience with RCP programs has been that taxpayers prefer initial contact by correspondence. This approach is consistent with Internal Revenue Service guidelines.

Taxpayers who failed to respond to the letters were assigned for field contact. Revenue officers making the contacts used a variety of tools legally available to them to resolve the leads. These included referrals for employment tax examinations, preparation of returns under IRC 6020b (refusal to file procedures), and referrals to Examination or Criminal Investigation Divisions. We would like to emphasize that a large proportion of the cases were resolved by taxpayer decisions to voluntarily comply with filing and payment requirements after fully discussing the issues with our employees. Use of administrative enforcement tools such as preparation of returns under IRC 6020b or referrals to Examination were generally only necessary when uncooperative taxpayers were encountered. Each of the administrative actions are subject to review by our Appeals Office and taxpayers were advised of their rights to appeal our decisions.

As 3a noted in 3d correspondence, the RCP dealing with truck owners was discontinued in early 1995. We found that most taxpayers were reporting income paid to their truck drivers, under either employee or self-employed contractor relationships. The Construction Trades RCP is ongoing. Our contacts will continue to emphasize education, community outreach, voluntary compliance, and appropriate enforcement to "level the playing field" so that taxpayers who are complying with applicable tax laws are not disadvantaged in their business dealings by those who choose to ignore their tax responsibilities.

We appreciate your interest in this matter and trust that the above information is fully responsive to the issues raised by your constituent. Should you desire additional information or clarification, members of your staff may contact W. Smith, Acting Chief, Problem Resolution Unit, at (904) 232-2046.

Sincerely yours,


Acting: Dale F. Hart
District Director

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Appendix VI



ASSISTANT COMMISSIONER
EXAMINATION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEC 21 1995

The Honorable Tillie K. Fowler
U. S. House of Representatives
Washington, DC 20515

Dear Ms. Fowler:

Commissioner Richardson has asked this office of the Internal Revenue Service (IRS) to reply to your inquiry in behalf of [redacted] expressed some concerns regarding the Construction Trade Returns Compliance Program (Returns Compliance Program) in the Jacksonville District. [redacted] states in [redacted] letter to you that the revenue officers in the Jacksonville District were not following IRS policy and procedures.

The Returns Compliance Program was discontinued earlier this year. However, we wish to assure you that the revenue officers assigned to the ~~Returns Compliance Program~~ were ~~all working in accordance with IRS policies and procedures.~~ In cases where referrals were necessary, the revenue officer did follow procedures in sending those cases to the Examination group. ~~Any decisions made by the revenue officer on the proper classification of workers were based on information furnished by the taxpayers.~~ Because of confidentiality, we cannot disclose any particulars of these cases with you. IRS revenue officers work with the revenue officer examiners and employment tax specialists whenever they come across a worker classification issue.

There are certain instances where a revenue officer can make his/her own determination in worker classification issues without having to consult an employment tax specialist. For example, if an employer was treating his workers as employees in a prior year then converted these same workers to an independent contractor status, then the revenue officer can make the reclassification. Also, if an employer just quit filing Form 941s, and based on facts and circumstances he/she must still file these forms, the revenue officer can file the forms. This authority is contained in section 6020(b) of the Internal Revenue Code. However, even in these instances, the taxpayer is still advised of his/her rights to appeal any decision reached by the revenue officer. Whether a taxpayer exercises these appeal rights is beyond our control.

I hope this information is responsive to your constituent's concerns.

Sincerely,

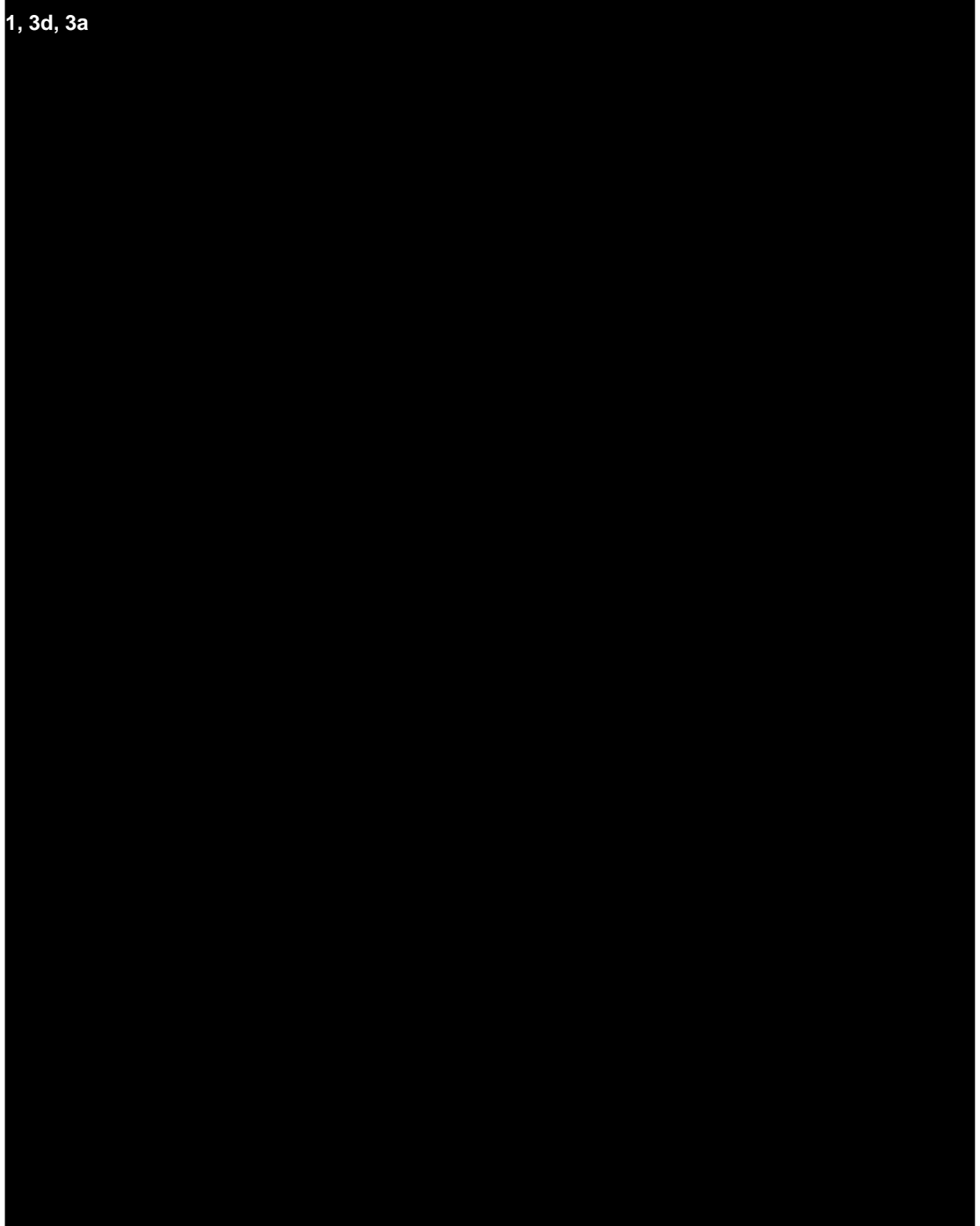
L. E. Carlow

cc: District Director, Jacksonville

**Internal Revenue Service Procedures Were Not Consistently Followed
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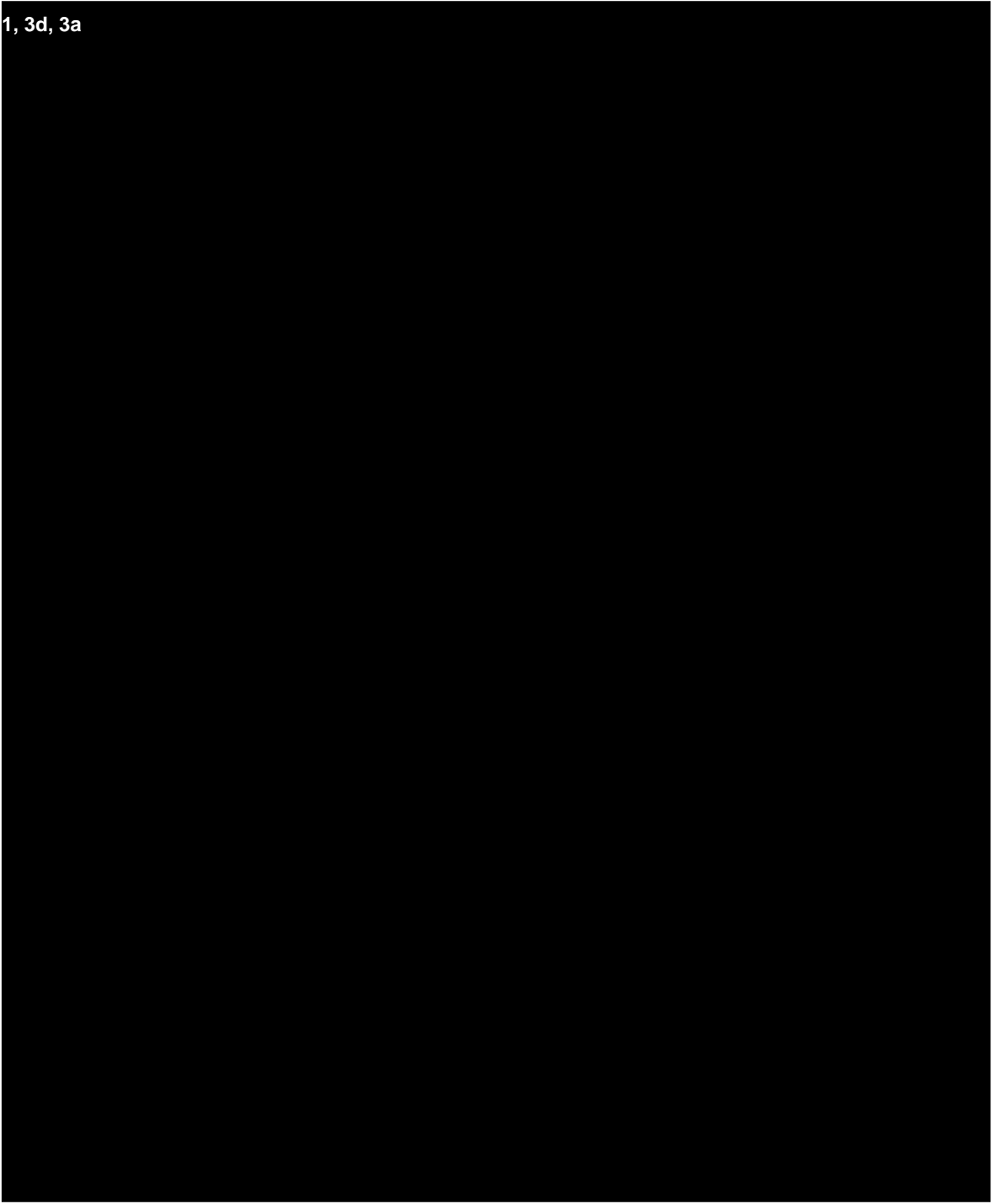
Appendix VII

1, 3d, 3a



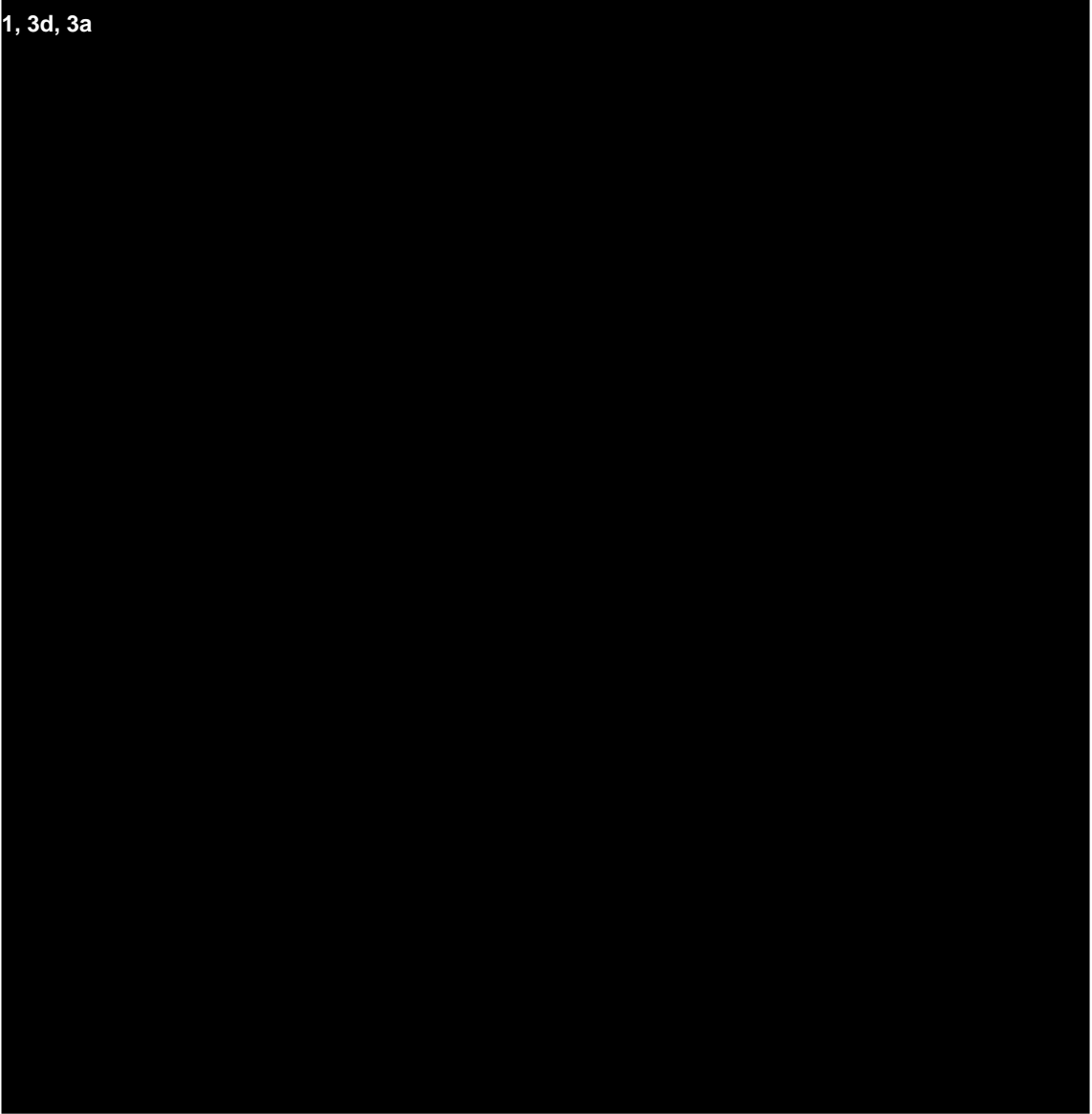
**Internal Revenue Service Procedures Were Not Consistently Followed
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1, 3d, 3a



**Internal Revenue Service Procedures Were Not Consistently Followed
When North Florida District Revenue Officers Attempted to Improve
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1, 3d, 3a



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Appendix VIII

Management's Response to the Draft Report

**Internal Revenue Service
memorandum**

date: NOV 24 1998

to: Regional Inspector
Southeast Region


from: Chief Compliance Officer
Southeast Region

subject: Draft Internal Audit Report: Review of the Regional Compliance Program (RCP)
Project for the North Florida District Construction Trades Industry – Urmem dated
August 31, 1998

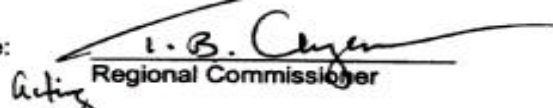
The North Florida District conducted a Construction Trade Regional Compliance Program (RCP) Project from October 1993 until September 1995 based on Compliance 2000 concepts. An internal audit review of the project identified three areas of concern. We agree that during the time period of the RCP project, there were two groups working employment tax leads using different procedures. We also agree that sufficient training was not provided to the revenue officers assigned to the RCP project. Since the project was terminated September 1995, there are no required corrective actions for these two findings.

On October 29, 1998, Internal Audit and the regional Compliance Officer agreed that an independent audit will be initiated by Internal Audit and Employment Tax Examiners in January 1999 to address the third finding. The purpose of the review is to determine whether an audit was conducted and if there is a potential that the taxpayer account is incorrect or inaccurate. The team will also assess whether there was any harm or inconsistent treatment to the taxpayer. If the review identifies any inconsistent treatment, counsel will be contacted to determine any remedial actions that must be taken.

Attached is our management response to address the third area of concern. If you have any questions regarding the above, please contact Compliance Analyst Judith Adams at (404) 331-5276.


Bobby E. Scott

Concurrence:


Regional Commissioner

11-25-98
Date

Attachment: As stated

cc: Regional Controller

**Internal Revenue Service Procedures Were Not Consistently Followed
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Attachment

3 Identity of Finding: Management did not ensure that revenue officers working RCP project employment tax leads followed the established IRM procedures for employment tax examinations.

Assessment of Cause: The North Florida District conducted a Construction Trades Regional Compliance Program (RCP) project October 1993 until September 1995. The RCP project was designed to improve compliance with employment taxes within the construction trades industry. Locally developed procedures as opposed to IRM 5(10) were utilized to verify employment tax compliance. Consequently, there were two groups within the district working employment tax leads and following different procedures. The Employment Tax Examination Group followed the procedures set forth in IRM 5(10) while the RCP group utilized the locally established procedures. This may have created an environment in which the taxpayer's right to fair treatment was at risk.

3-1 Recommendation: Internal Audit will jointly review the cases with independent Employment Tax Examiners to determine whether or not taxpayers were treated inconsistently.

3-1-1 Corrective Action: An independent review of the cases will be conducted in January by Internal Audit and Employment Tax Examiners to determine whether examination audits were conducted. If so, were the tax laws appropriately applied and the proper amount of tax assessed. Counsel will be contacted for advice on how to handle any potential problems.

Original Projected Completion Date:	5/1/99
Current Projected Completion Date:	5/1/99
Actual Completion Date:	
Responsible Official:	Chief, Compliance Officer
Status:	Proposed